LEGISLATIVE SERVICES AGENCY
OFFICE OF FISCAL AND MANAGEMENT ANALYSIS

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FISCAL IMPACT STATEMENT

LS 6793 **DATE PREPARED:** Mar 23, 1999
BILL NUMBER: SB 189 **BILL AMENDED:** Mar 22, 1999

SUBJECT: Financial Institutions Tax.

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FUNDS AFFECTED: X **GENERAL**
DEDICATED
FEDERAL

IMPACT: State

Summary of Legislation: (Amended) (A) This bill exempts interest received from United States Treasury obligations from the Financial Institutions Tax.

(B) This bill treats resident financial institutions the same as nonresident financial institutions for purposes of the Financial Institutions Tax (FIT) by providing that the tax is imposed upon the apportioned Indiana income of financial institutions. (Current law imposes the Financial Institutions Tax on the adjusted gross income of resident financial institutions.)

Effective Date: (Amended) January 1, 1999 (retroactive), January 1, 2000.

Explanation of State Expenditures: (Revised) The Department of Revenue will have some administrative expenses associated with changing tax forms, instructions and computer programs to implement these changes. These expenses will be covered under their existing budget.

Explanation of State Revenues: (Revised) (A) This bill exempts interest received from United States Treasury obligations from the Financial Institutions Tax (FIT) beginning January 1, 2000. Interest earnings from United States Treasury obligations represents a significant portion of income earned by financial institutions. Based on data from the Federal Deposit Insurance Corporation (FDIC), it is estimated that Indiana banks had approximately $527 M in interest earnings from U.S. Treasury securities and U.S. Government agency obligations. Financial institutions also had $83 M in interest earnings from other debt securities (which would include U.S. Treasury securities.) Based on the assumption that a portion of these interest earnings are attributable to U.S. Treasury securities, this new exemption will reduce FIT revenue by approximately $24 M to $34 M annually. FIT revenue for FY 98 was $96 M and revenue collections are deposited in the General Fund. This change would affect revenue collections beginning in FY 2000 with quarterly payments with a full annual impact first affected in FY 2001.

(B) This bill changes the way that Indiana domiciled companies are taxed under the FIT to only include their apportioned income on earnings made in the state. This bill would make the FIT apply to all financial institutions on the same base of Indiana receipts.

Under the current statute, there are two different formulas for calculating the FIT depending on where the financial institution is domiciled. For Indiana domiciled financial institutions, their tax base is calculated using their total income earned in and out of state. FIT allows a credit to be taken for taxes paid to other states. This was done to capture income earned in another state due to Indiana's application of "economic nexus" where another state would not tax that income because there was no "physical nexus." This is sometimes referred to as "no where income."

Currently, out of state domiciled financial institutions report only their Indiana income earned in the state and use a one factor apportionment formula of receipts attributable to Indiana versus total receipts.

Prior to June 1, 1997, banks were required to establish a holding company that was incorporated and domiciled in each state where business was conduct. These corporations were defined as "resident" taxpayers under the FIT. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Riegle-Neal) authorized interstate mergers between banks beginning June 1, 1997 regardless of whether the transaction would be prohibited by state law. The Riegle-Neal Act gave states the right to opt out of this arrangement if they pass legislation prohibiting mergers with out-of-state banks before June 1, 1997. Indiana did not pass any legislation prohibiting mergers, therefore the Riegle-Neal Act now applies to all financial institutions operating in Indiana. With the advent of interstate banking, financial institutions who could not expand across state lines may now do so and some multi state holding companies are combining their operations into single state banks with multi-state branches.

In essence, the Riegle-Neal Act has given financial institutions an incentive to reorganize and change their corporate structure to benefit from greater administrative efficiencies. However, many of the larger banks have found that the rate of taxation for an Indiana resident taxpayer with all its consolidated subsidiaries is greater than it was before when under the former organizational structure only its Indiana holding company was taxed as an Indiana resident. This has caused a number of institutions to change their commercial domicile so that they are now taxed as a nonresident based only on their Indiana income.

An example of how the deregulation and reorganization of banks has affected their calculation of FIT follows:

Prior to deregulation: An Indiana domiciled company with a subsidiary in Illinois (IL) and Kentucky (KY) would calculate their adjusted gross income (AGI) and apportionment factor (factor) by in the following manner:

$$\text{factor} = \frac{\text{All its IN parents receipts + Indiana share of its IL subsidiary + Indiana share of its KY subsidiary}}{\text{All its IN parents receipts + all its IL's subsidiary receipts + all its KY's subsidiary receipts}}$$

IN AGI x factor (< 100%) = Franchise Tax Income

Franchise Tax Income x FIT tax (8.5%) - taxes paid to other states

Scenario 1. After deregulation: If an Indiana domiciled company merged its Illinois (IL) and Kentucky (KY) subsidiaries into divisions the following calculations would be made:

$$\text{factor} = \frac{\text{All its IN parents receipts +all its IL's branch receipts + all its KY's branch receipts}}{\text{All its IN parents receipts + all its IL's branch receipts + all its KY's branch receipts}} = 100\%$$

IN AGI x 100% factor = Franchise Tax Income

Franchise Tax Income x FIT tax (8.5%) - taxes paid to other states

Scenario 2. After deregulation: If an Indiana domiciled company changes its state of domicile to Illinois (IL) and merged its Indiana and Kentucky (KY) subsidiaries into divisions the following calculations would be made:

$$\text{factor} = \frac{\text{Indiana branch receipts only + its IL's parent IN receipts + Indiana share of its KY branch}}{\text{All its IN branch receipts + all its IL's parents receipts + all its KY's branch receipts}}$$

IN AGI x factor (< 100%) = Franchise Tax Income

Franchise Tax Income x FIT tax (8.5%) - taxes paid to other states

If a financial institution reorganized and maintained Indiana as their state of domicile, their apportionment factor would also increase and they would be subject to paying more FIT to Indiana. The credit paid to other states has not been enough of a factor to negate the increase in FIT liability. (For example the Illinois tax rate is 7.3%; Kentucky's tax rate is 1.1% of net capital; Wisconsin is at 7.9%.) This has caused a number of financial institutions to look into changing their state of domicile for the parent company in order to reduce their level of taxation.

According to the Department of Financial Institutions there were 155 state charter banks and savings and loans as of January 14, 1999. Thirty three banks have dissolved their state charter in the last two years. With 651 FIT filers in FY 97, these state charter banks make up 24% of the number of financial institutions in the state. After review of the 1997 FIT returns, the DOR has determined that many of the large national banks are already apportioning their Indiana income and reporting as nonresident banks. This may be reflective in the decrease in FIT revenue for FY 98 which was $95.6 M in FY 98 in comparison to $100.7 M in FY 97.

The fiscal impact of changing the base of adjusted gross income of financial institutions to include only their Indiana receipts will affect FIT revenue in two ways. First, if one assumes that any institution which can now change their state of domicile to reduce their tax liability will do so absent this bill, then this change will not affect that eventual revenue loss. The state will only lose revenue from those Indiana banks that have income earnings in states where they do not have a physical presence and now under this bill they would only have to report their Indiana receipts.

Secondly, this change will eliminate the state's ability to use economic nexus to tax "no where income." However under deregulation it appears that Indiana has already lost its ability to use economic nexus to tax "no where income" from the majority of financial institutions operating in Indiana and only those remaining state domicile banks are including this income in their base. This has created a disadvantage for Indiana domiciled banks.

It is estimated that this change will result in a *net* revenue loss of less than $5 M annually in FIT collections. This assumes that FIT collections will continue to be affected by deregulation absent this bill and the additional loss of FIT would be from Indiana domicile banks who do not have enough of an incentive to change their state of domicile. This change applies to tax years beginning January 1, 1999 and will affect revenue collections beginning in FY 2000. FIT revenue is deposited in the General Fund.

Explanation of Local Expenditures:

Explanation of Local Revenues: Local units of government receive a guarantee distribution of FIT revenue so there will not be any changes in local revenues.

State Agencies Affected: Department of Revenue.

Local Agencies Affected:

Information Sources: Department of Revenue; Federal Deposit Insurance Corporation Research Database.